

Removing the Toll-Gate to the Middle Class By Eliminating the Middle Class Parent Penalty

Testimony of
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Mr. Chairman, Ranking Member Baucus, distinguished members of the Committee. It is a great honor to appear before you today to discuss child tax credits.

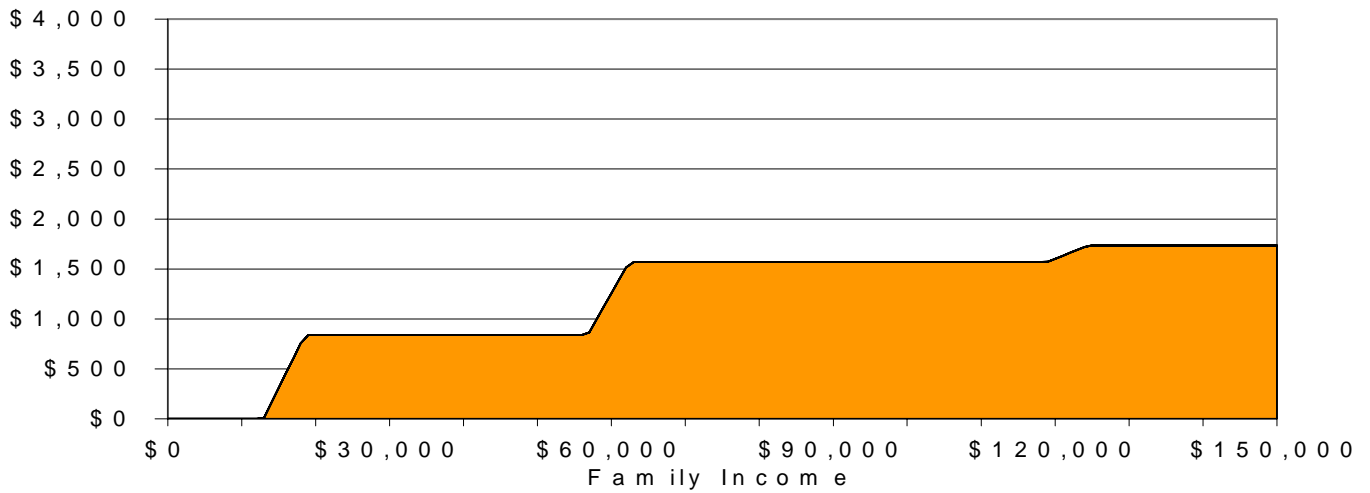
Over the years, lawmakers have enacted a variety of tax policies designed to help families with children. These policies make a critical difference in the lives of many citizens. Now President Bush has proposed significantly expanding that support by doubling the current child tax credit from \$500 to \$1000. The President properly recognizes the need to focus particular help on parents who struggle to nurture and provide for their children in an increasingly complex world.

Yet ironically, when we look at the combined effects of the various different supports for children, we find that they provide the greatest benefits for the working poor and the wealthy, while doing far less for middle income families. Thus our current system creates a kind of middle class parent penalty. Not only does this seem unfair to the middle class, it also creates what President Bush has properly labeled the “toll-gate to the middle class.” As a working poor family’s income rises through either work or marriage, and the family moves towards the middle class, they stand to lose sizable tax benefits. They face both high marginal tax rates and sizable marriage penalties. And the hodgepodge of child benefits that create these problems also adds complexity to the tax system.

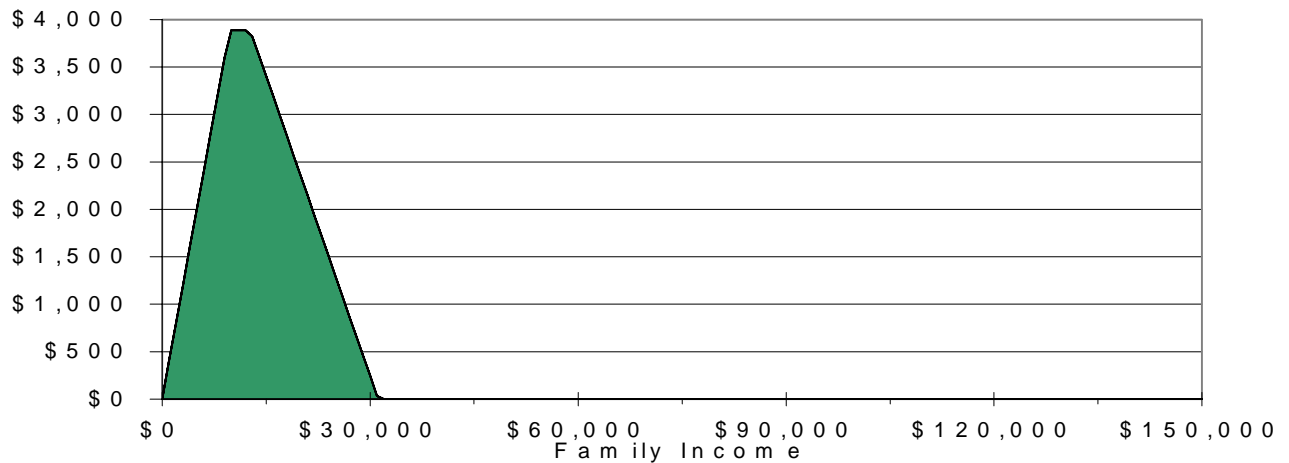
Major Child Tax Benefits

There are three major benefits tied to children in the tax code: the dependent exemption, the Earned Income Tax Credit, and the child tax credit. Interestingly each offers different benefits to families at different incomes. The pattern of benefits are shown below.

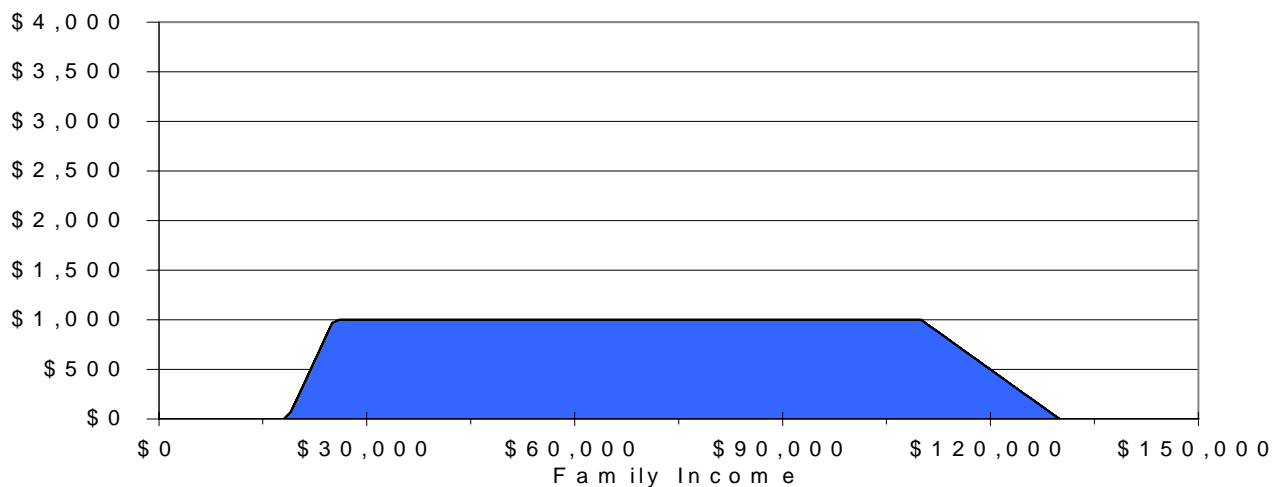
Value of the Dependent Exemption for Two Children in a Married Couple in 2000



Value of the Earned Income Tax Credit for a Family With Two Children in 2000



Value of the Existing Child Tax Credit and Proposed Bush Expansion for Two Children in a Married Couple in 2000



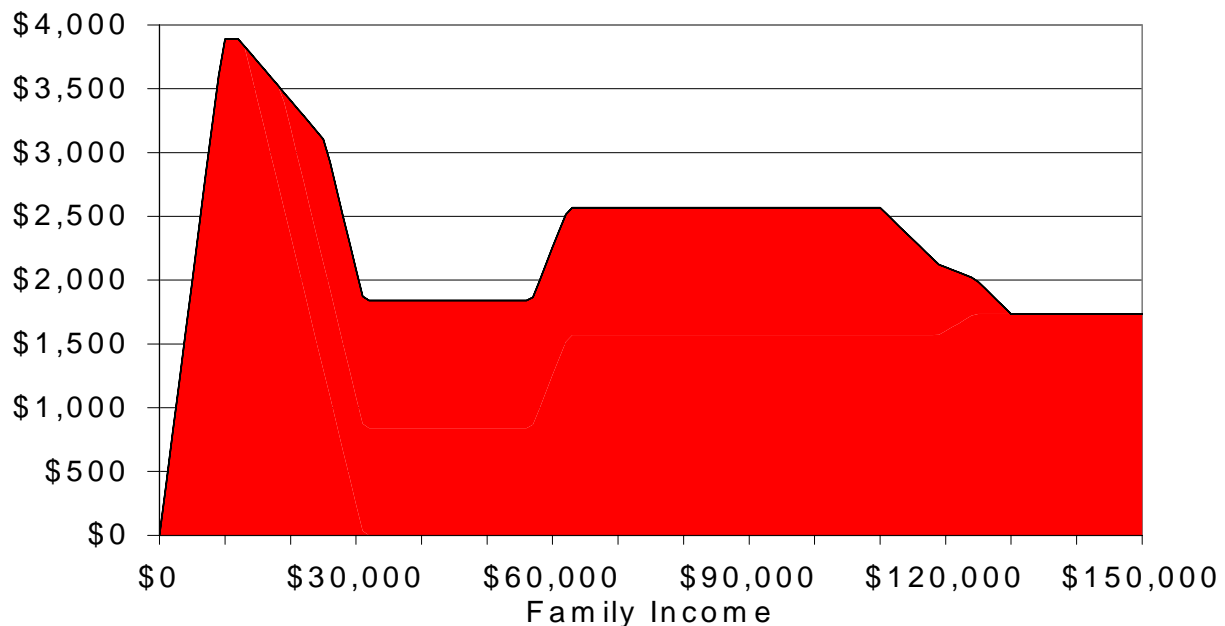
The *dependent exemption* reflects the added expenses of children and allows parents to deduct \$2,800 for each child they support. As with any deduction, its value rises as the tax bracket rises. Thus it has no value for people who owe no taxes. For a family in the 15% bracket with two children, it is worth \$840. For a family in the 31% bracket, it is worth \$1736.

The *Earned Income Tax Credit (EITC)* was introduced in 1975, in part as a way to offset the payroll taxes that low-income taxpayers must pay. It was expanded greatly under Ronald Reagan who called it the "the best antipoverty, the best pro-family, the best job-creation measure to come out of Congress." The credit is targeted on families with full-time earnings around the minimum wage who can get the maximum benefit of almost \$4,000. Families with incomes above \$32,000 get nothing at all. It is fully refundable, meaning families can get the credit regardless of their taxes owed.

Finally there is the \$500 per *child tax credit* which was adopted in 1997 and that President Bush would like to double. The credit is non-refundable, so it only helps people with tax liabilities. Married couples must typically have incomes over \$25,000 to get the full benefits of the credit. The credit is phased out starting at \$110,000 for a married couple.

Each of these make sense in isolation. But when combined the total benefit is shown below:

Figure 4
Combined Value of Child Tax Benefits From EITC, Exemptions, and Child Tax Credit
Married Couple with Two Children



Benefits for families in the \$30,000 to \$60,000 range are considerably lower than those for families near \$15,000 or \$100,000. This dip in benefits is the middle class parent penalty.

Why Is The Middle Class Parent Penalty Important?

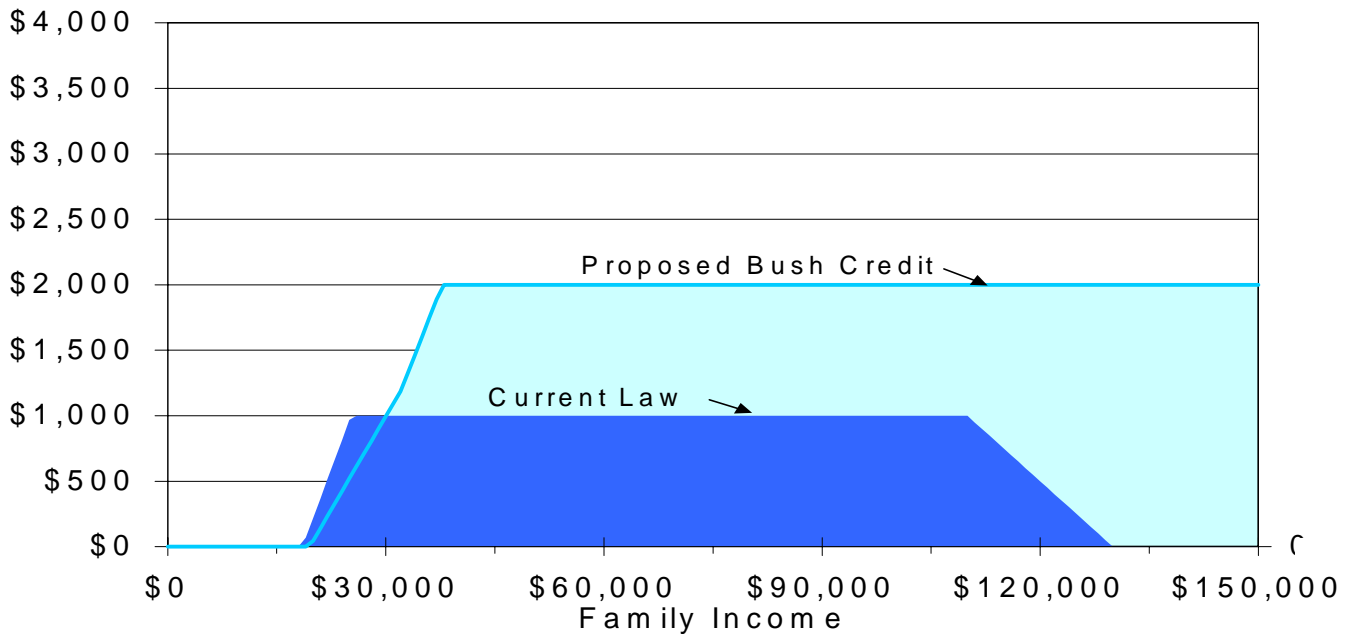
- Equity—It is hard to understand why the nation offers support for children in such different ways and why it chooses to provide more aid to higher income parents than to middle income ones.
- High marginal tax rates—Child tax benefits fall off particularly sharply at incomes between \$25,000 and \$32,000. Because child tax benefits are being cut so sharply as earnings rise, working parents face effective marginal income tax rates over 35% and over 40% if payroll taxes are included. If one takes account of the loss of other benefits such as food stamps or child care subsidies, effective tax rates for families in the range of \$20,000 to \$30,000 can reach 80%.
- High marriage penalties—When a mother of two who earns \$15,000 marries a childless man earning the same amount her family income rises from \$15,000 to \$30,000. As a result she loses many of her child tax benefits. This serves as a marriage penalty. Indeed such a couple will pay \$2,700 more in taxes if they marry. As a percent of their income, this penalty is vastly higher than the penalty for couples at almost any other income level.
- Complexity and Errors— The array of child related tax benefits have conflicting rules about who can claim which children that lead to confusion, errors, and even fraud. A family can sometimes quite legally claim one type of child benefit, but be breaking the law if they claim another.

Strategies for Reducing the Middle Class Parent Penalty

The Bush Tax Credit

President Bush has offered a sizable tax cut plan which includes reductions in marginal tax rates, an increase in the child tax credit from \$500 to \$1000, and changes the rules so that the child credit does not begin to phase out until family income reaches nearly \$200,000. The value of this credit to families at different incomes can be seen below.

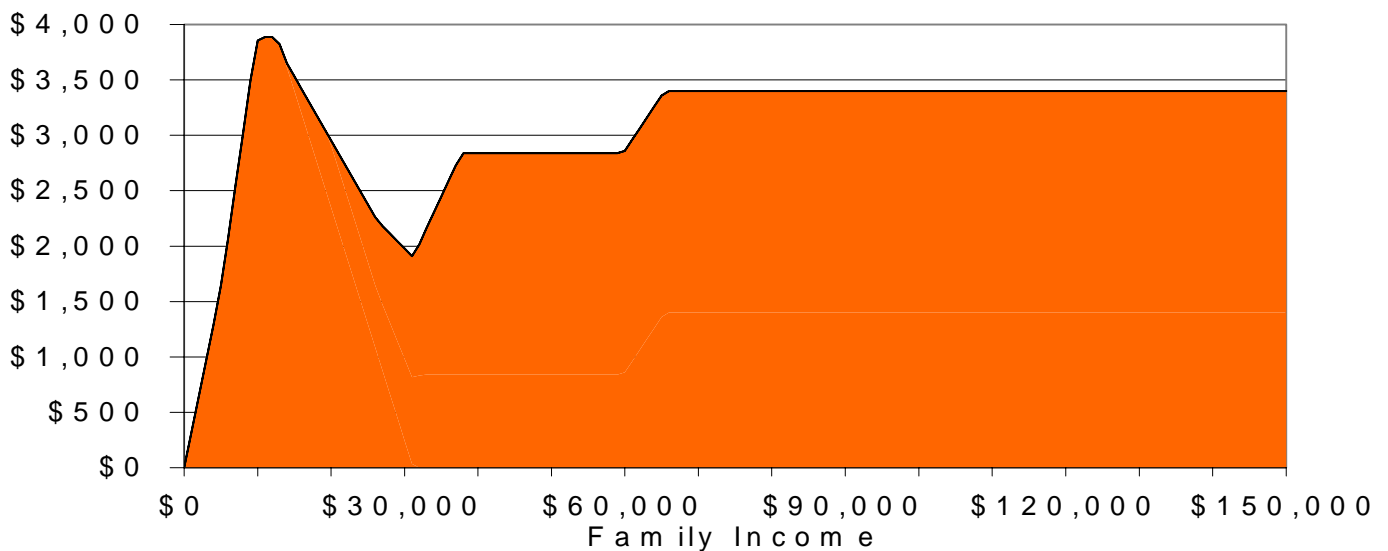
The Bush Child Tax Credit As Compared To Current Law



Thus a family earning \$60,000 with two children would get twice as much in credits as before. Because the benefits are in the form of a child credit increase which can only be used to offset taxes, a couple with two children would not qualify for the full credit until their income reached at least \$36,000—more if they have 3 or more children. Nearly half of all children in *tax-filing families* would not get the full credit. The biggest winners from the child credit proposal would be families with incomes over \$130,000.

The combined child tax benefits that will exist if the entire Bush plan were adopted, including the tax credits, altered marginal rates, and marriage penalty relief are shown below.

Figure 5: Combined Value of EITC, Child Exemptions and Child Tax Credits Under Bush Proposal



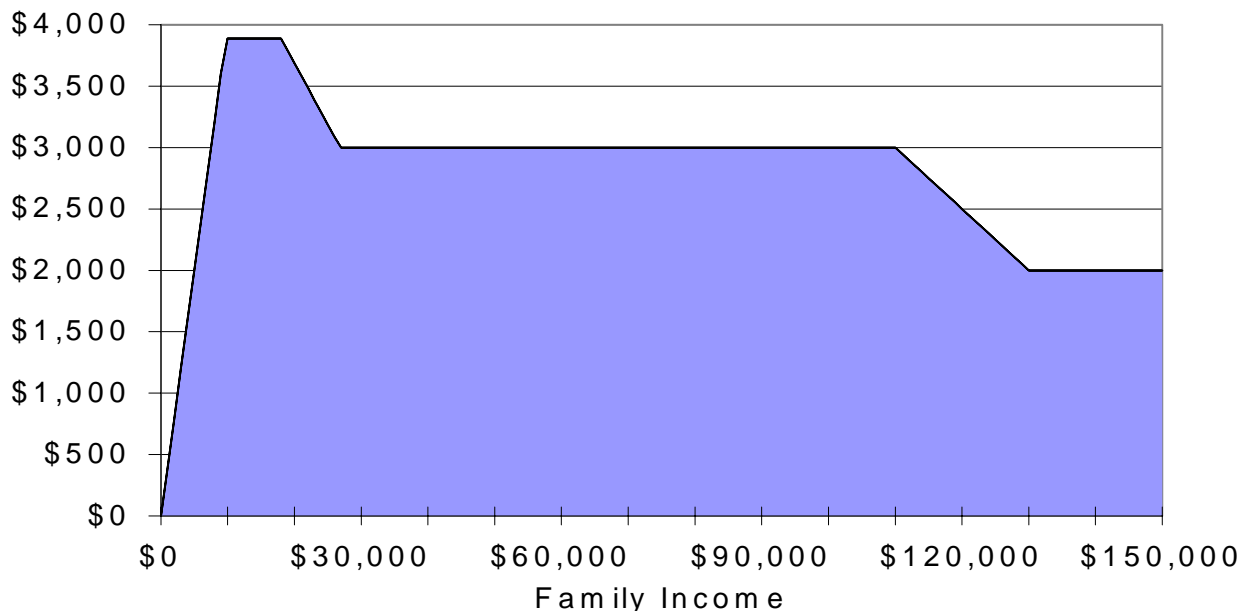
The Bush plan helps families with incomes over \$25,000. It does reduce marginal tax rates. At the same time, one can see that a sizable middle class parent penalty remains. Families earning \$30,000 get far less support than those who are richer.

Unfortunately this plan does little to reduce the marriage penalty facing a single parent earning \$15,000. Marriage penalties would fall just from \$2,700 to \$2,400. Indeed the conservative Heritage Foundation has proposed spending an additional \$5 billion per year for “more effective use of the Earned Income Tax Credit to promote stable marriage among low income parents.”ⁱ

A Unified Child Tax Credit for Working Families

An alternative plan is to create an integrated child tax credit, one with a single definition for children that could replace the three benefits in current law. Under this plan, benefits would phase-in just as the current EITC does. It would have a three tier benefit structure for a family with two children: \$3,888 (comparable to the maximum of the EITC) for families with incomes between \$10,000 and \$18,000, phasing down very gradually (at a 10 percent rate) to \$3,000 (\$1,500 per child) for families between \$30,000 and \$110,000, and phasing down again to a benefit of \$2,000 (\$1,000 per child) for families with incomes above \$130,000. The structure of benefits for a family with two children is shown below. The plan would also increase support for working families with three children. Such families could qualify for the full \$1,500 per child when family income reached just under \$10,000.

Figure 6: Unified Child Tax Credit for Working Families--Three Tier System



An integrated system such as this would target more support on middle class families, do even more to reduce tax rates that constitute the tollgate to the middle class, significantly reduce marriage penalties, and simplify the tax system. No longer would parents have to compute multiple different credits and exemptions each with their own rules and face a situation where one benefit is phasing in while another phases out. It would add to the cost of a tax plan, but only slightly more than the \$5 billion per year proposed by the Heritage Foundation for marriage penalty relief.

Other Proposals

Other proposals that bear on child tax benefits include other unified credit plans such as one suggested by Cherry and Sawickyⁱⁱ, making the child tax credit partially refundable for working families as proposed by Sawhill and Thomasⁱⁱⁱ, creating a refundable tax credit for payroll taxes paid, extending the EITC plateau for married couples to provide marriage penalty relief, making the child credit fully refundable. Each of these would do more to help working families in the middle class. Each has its own strengths and weaknesses. I would be happy to discuss any of these with you.

ⁱ **Antonelli, Angela M., and Peter B. Sperry.** "(600) Earned Income Tax Credit." in *A Budget for America*. Washington, D.C.: The Heritage Foundation, 2001. p. 285.

ⁱⁱ **Cherry, Robert, and Max B. Sawicky.** "Giving Tax Credit Where Credit is Due. A 'Universal Unified Child Credit' that expands the EITC and cuts taxes for working families." Briefing Papers. Washington, D.C.: Economic Policy Institute, 2000.

ⁱⁱⁱ **Sawhill, Isabell, and Adam Thomas.** "A Tax Proposal for Working Families With Children." *Welfare Reform and Beyond*. Policy Brief No. 3. Washington, D.C.: The Brookings Institution, 2001. Thomas (2001)